MERCER

Investment Consulting

December 16, 2005

Total Fund Review – Third Quarter Board Meeting
Arizona State Retirement System

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Economic Environment

Economy Growth: Moderate and Steady

- Hurricanes Katrina and Rita made it difficult to interpret the data for the third quarter, but the Fed's preliminary report showed that growth was fairly robust. The initial government estimate of third- quarter GDP growth was 3.8%.
  - Job growth was solid in July and August, but turned negative in September following Katrina. The unemployment rate rose to 5.1%, up slightly since last quarter.
  - Consumer confidence plummeted in September amid concerns over rising energy prices. Retail sales remained strong as the negative impact of Katrina was offset by higher gas prices and recovery-related spending.
- Overall, the housing market remained strong. Although new home sales and building permits fell in August, housing starts jumped in September and sales of existing homes and home prices continued to rise.

Economy Growth: Moderate and Steady

- For the quarter, industrial production was down 1.2% (and down 1.3% for September), retail sales were flat, and housing starts were up 2.1%.
- Tax receipts at the federal, state, and municipal levels remain stronger than expected, indicating a healthy economy. The federal budget deficit declined for the first time in years.
- Currently, economic growth appears average, right around the 3.4% average growth rate since 1959.
- Non-consumer sectors such as IT and capital goods are very strong
- Overall, the economy is performing better than many people believe

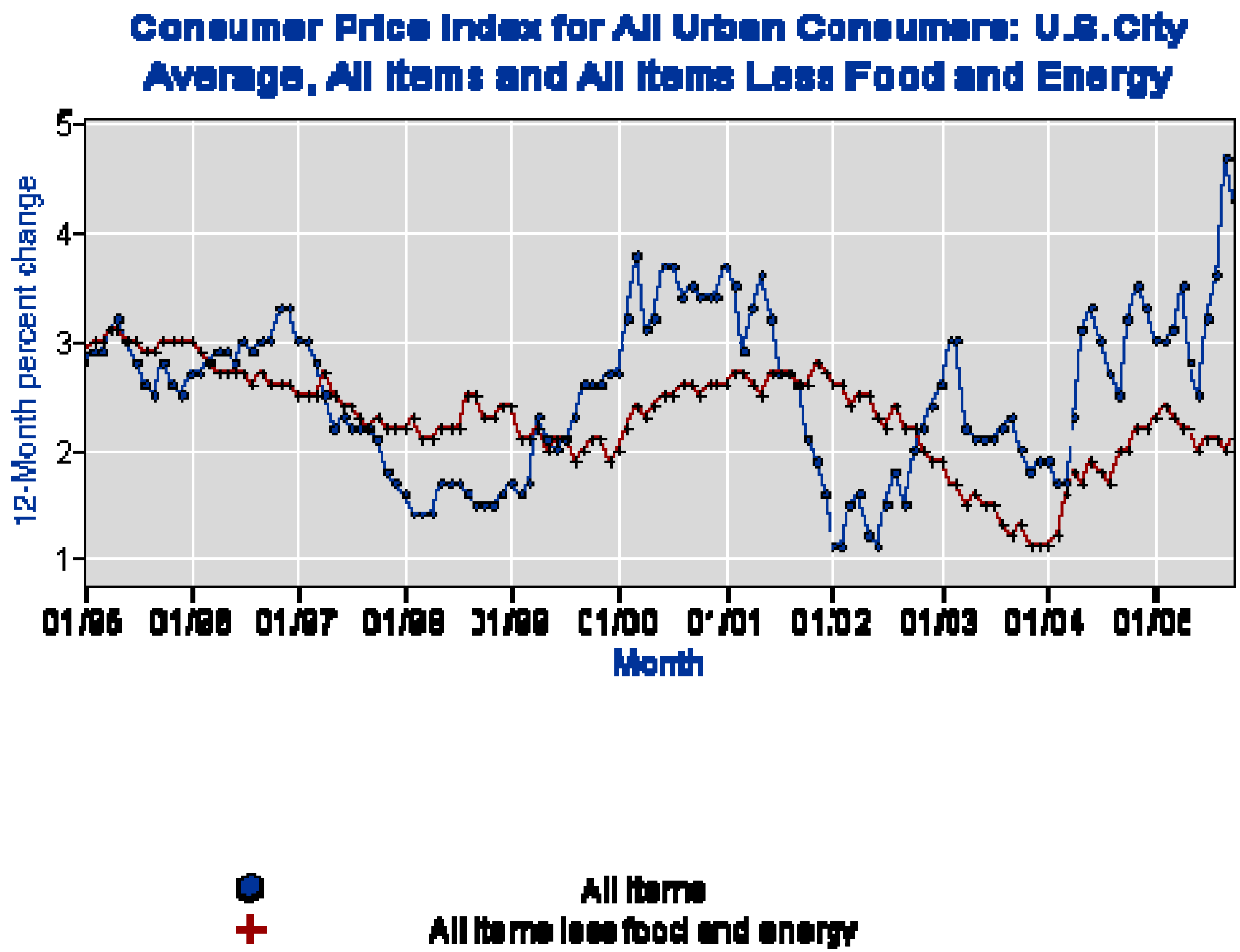
Inflation Returns!
Just in Time for a New Fed Chairman

- Inflation was at one of its highest levels in over a decade. Over the trailing year through September, the CPI was up 4.7%.

	2004				2005		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Quarter Change	1.7%	1.2%	0.1%	0.2%	1.6%	0.6%	2.2%
Y-o-Y Change	1.7%	3.3%	2.5%	3.3%	3.1%	2.5%	4.7%

- Energy prices were the main culprit, as the energy component of the CPI was up 21.4% in the third quarter and up 34.8% over the trailing year.

Inflation Returns!
Just in Time for a New Fed Chairman



Inflation Returns!
Just in Time for a New Fed Chairman

- But the inflation is not broad-based, which is why Fed officials are concerned but not alarmed. Core CPI, which excludes food and energy prices, is up 2.0% over the trailing year, right in line with its targets. The Producer Price Index was up 3.2% for the quarter and is up 6.9% over the trailing year.
- Breakeven inflation increased during the quarter. In June, the breakeven inflation as measured by the difference between 10-year nominal and real yields was at 2.3%, but rose to 2.6% by the end of September. It has slipped back down to 2.5% since the beginning of the month.
- Going forward, we continue to affirm 2.5% as our estimate of inflation for the next year as well as the long run.

Meet the New Fed Chairman
No Radical Changes Expected

- As expected, Ben Bernanke was nominated to replace Alan Greenspan as the new chairman of the Federal Reserve, and he should be easily confirmed by the Senate.
- Bernanke's overall approach will be very similar to Alan Greenspan's.
  - Currently, he advocates no change in the "measured" pace of increasing interest rates and doesn't believe that inflation is out of control.
  - Like Greenspan, Bernanke will be polite and politically adept with Congress and the Administration, but will deftly criticize them for their spending, regulatory, and protectionist inclinations.

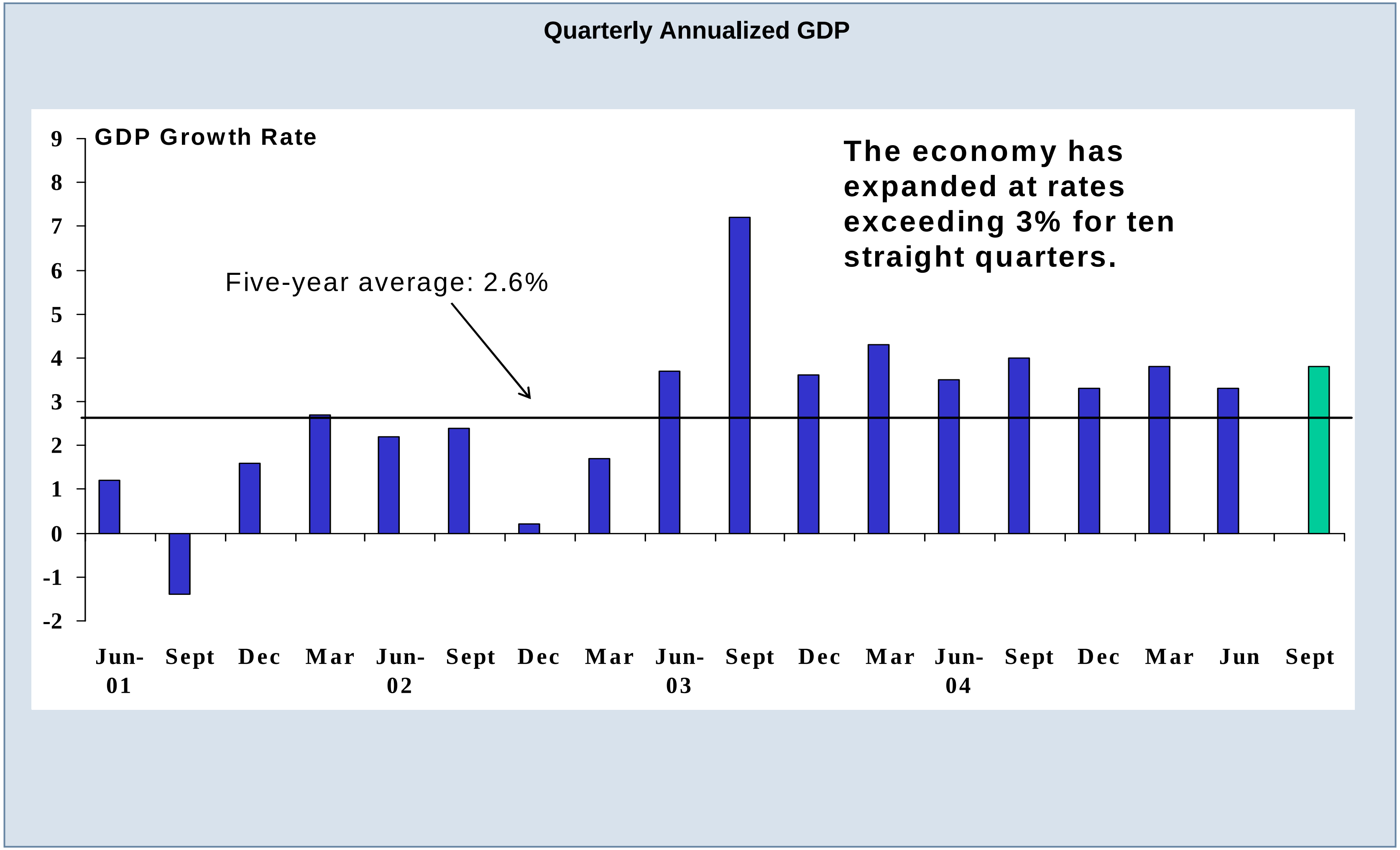
Meet the New Fed Chairman
There are Some Differences, However

- There are differences between Bernanke and Greenspan.
  - Bernanke believes in clearly articulating an inflation target.
  - He may be more “model” driven.
    - Greenspan is very willing to adapt his economic thinking to the circumstances. (For example, he postulated on the deflationary effects of productivity during the 1990s.)
    - The inscrutable Greenspan was brilliant at never getting pinned down on what the Fed’s target inflation or full-employment objectives were.
- In the long run, Benanke does face some considerable challenges. The recovery is getting “mature,” real estate may be at a bubble phase, consumers are levered and savings is quite low, and the trade deficit is high.

Meet the New Fed Chairman
The Fed's View of the State of the Economy

- Even amid the concerns about the impact of the hurricanes, Fed officials believe that the economy is reasonably healthy at the moment. Energy prices, and to some extent low interest rates of the last few years, have had an inflationary effect, but this is a short-term phenomenon and should dissipate over the next year.
- Fed Fund futures contracts imply that the Fed will raise interest rates to 4.25% by the end of the year and to 4.5% in the spring. (In contrast, our Fearless Forecast participants at the beginning of the year projected the Fed Fund rate to rise to 3.2% by the end of the year.)
- Fed policy is finally moving into the restrictive range. Core inflation is around 2.0% to 2.5%, so we are beginning to see sizable short real interest rates.

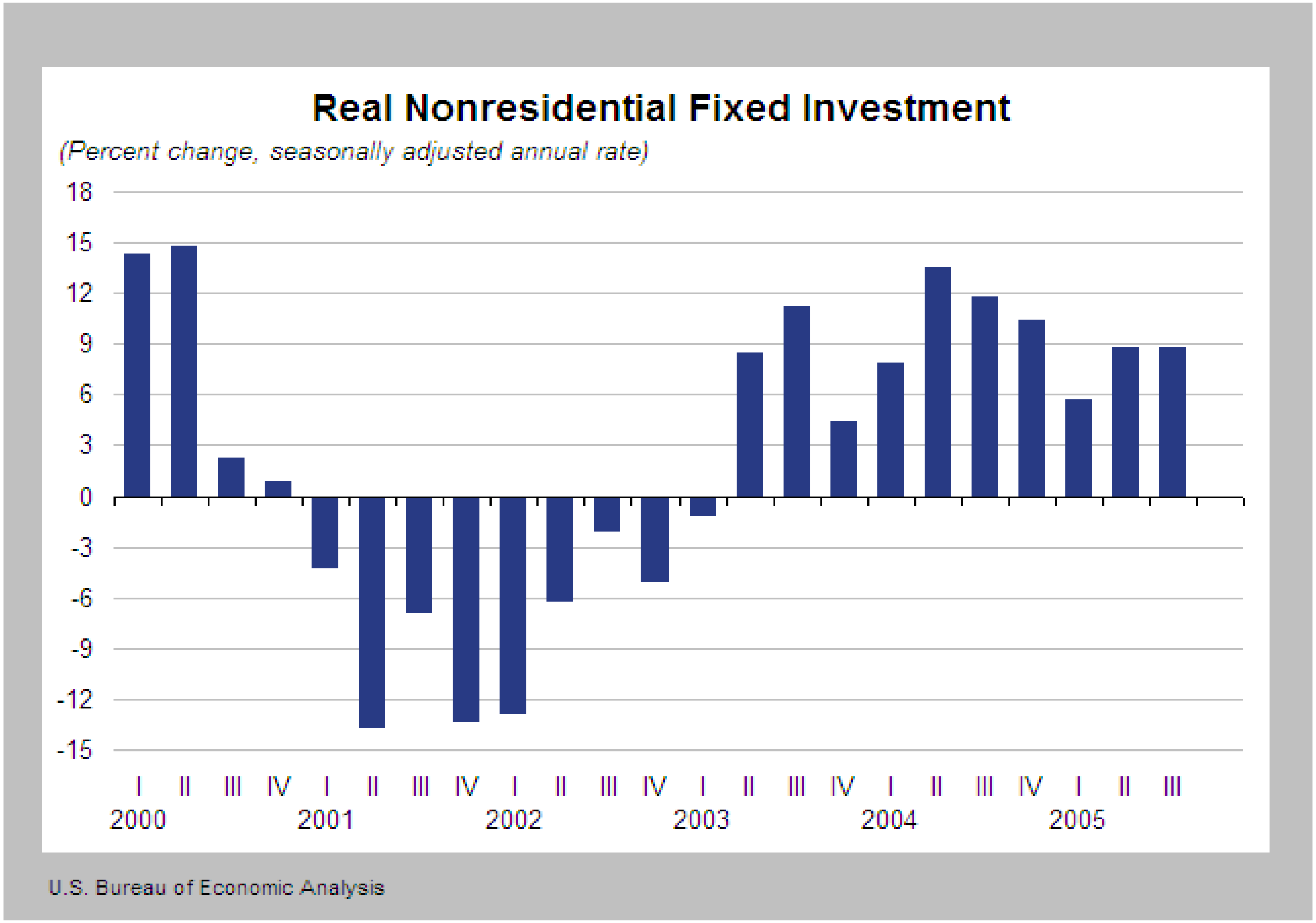
Steady Growth: GDP Shows 10 Consecutive Quarters At or Above 5-Year Average



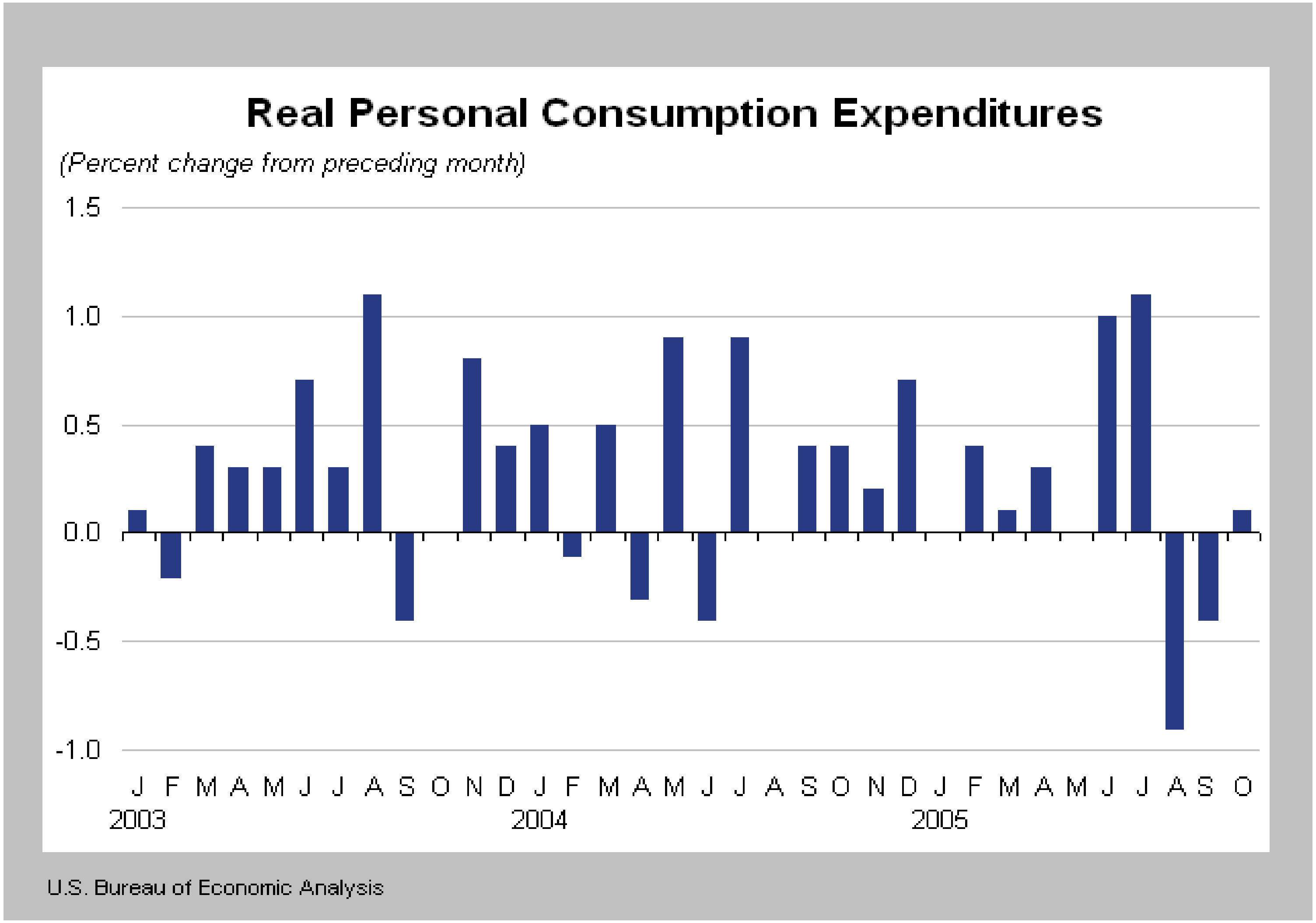
Unemployment Continued Its Downward Trend

Note: Cross-hatched area represents recession.

Corporate Capital Spending Continues Strong



Consumer Spending Down Significantly
Energy Prices and Housing Prices Are Factors



Outside the US: Global Growth

- After several jolts (rejection of the EU constitution, terrorism in London, and a gridlock election in Germany), Europe has probably hit its lows and should start to rebound. The capital markets certainly think so, as equity returns in Europe during the third quarter were quite strong.
- In July, China dropped its dollar peg. Although the initial impact is minuscule, this event offers great flexibility to China in the long run. By adopting a currency basket and gradual adjustment, China appears to have the best of both worlds: it drops the peg, and prohibits any crisis while its financial system matures and adapts to the requirements of flexible exchange rates.
- Many analysts are also positive about Japan.
- After ten months of steady appreciation against almost every currency, the dollar is expected to start to decline again.

Securities Markets

U.S. Equity Markets
Stocks Driven by Energy, Utilities, and Technology

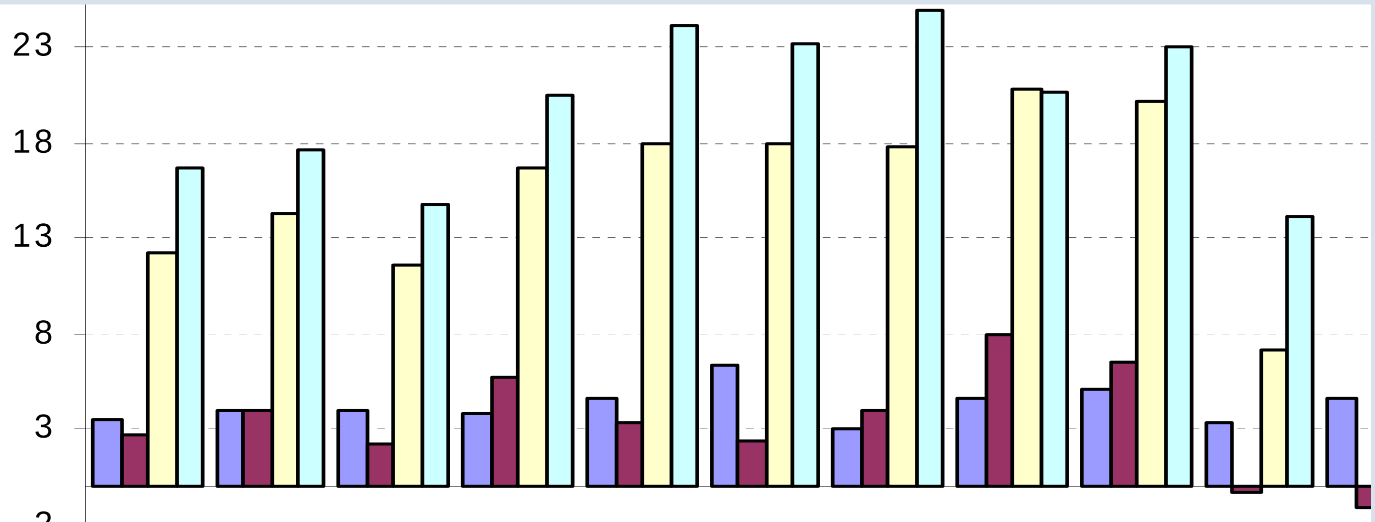
- The stock market held up well during the third quarter despite higher energy prices, rising short-term interest rates, airline bankruptcies, and devastating hurricanes. The S&P 500 Index gained 3.6%, while the Russell 1000 Index advanced 3.9%.
- Strong performance in July helped push small cap stocks ahead of large caps during the quarter as the Russell 2000 Index gained 4.7%. Small cap growth stocks, up 6.3%, led small cap value stocks, which gained 3.1%.
- Large cap growth stocks held a small edge over their value counterparts as the Russell 1000 Growth Index gained 4.0%, while the Russell 1000 Value Index advanced 3.9%.

U.S. Equity Markets
Stocks Driven by Energy, Utilities, and Technology

- Natural-resource stocks were the top performers as the energy and integrated oils sectors gained 31.2% and 14.0% respectively. Consumer discretionary & services, down 0.7%, was the weakest-performing sector, followed by financial services, which eked out a 1.1% gain.

U.S. Equity Markets
Index Performance

Domestic Equity Returns



	S&P 500	Russell 1000	Russell 1000 Growth	Russell 1000 Value	Russell 2000	Russell 2000 Growth	Russell 2000 Value	S&P Mid Cap*	S&P Small Cap*	DJIA	Nas
Quarter	3.60	3.95	4.01	3.88	4.69	6.32	3.09	4.58	5.14	3.44	4
YTD	2.77	4.06	2.22	5.72	3.38	2.51	4.02	7.99	6.51	-0.34	-1
1 Year	12.25	14.26	11.60	16.69	17.95	17.97	17.75	20.76	20.10	7.23	13
3 Year	16.72	17.65	14.74	20.48	24.12	23.23	24.89	20.70	23.07	14.19	22

*Source: Datastream; *Price Return Only*

Quarterly Returns Are Single-Digit Positive

- Growth is outperforming value across the cap ranges.
- Mid cap growth was the best place to invest.

3Q05	**Value**	**Core**	**Growth**
Large	**3.88**	**3.94**	**4.01**
Mid	**5.35**	**5.92**	**6.55**
Small	**3.09**	**4.69**	**6.31**
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

One-Year Returns Differ Significantly by Style

- Very strong results for mid-cap across the style spectrum.
- Value was generally the place to be, but that is changing.

1-Year Returns	Value	Core	Growth
Large	16.67	14.24	11.58
Mid	26.09	25.09	23.48
Small	17.72	17.92	17.94
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

Three-Year Results Show Narrowing Variations

- Returns, except for large core and growth, are well above long-term expectations.
- Even large growth has improved dramatically.

3-Year Returns	**Value**	**Core**	**Growth**
Large	**20.47**	**17.66**	**14.75**
Mid	**26.65**	**25.99**	**24.93**
Small	**24.91**	**24.13**	**23.22**
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

Cumulative 3-Year Results Are Strong

- Returns for all are excellent; we had an excellent recovery.
- Mid-cap is up more than 90% across the style spectrum.

Cumulative 3-Yr	Value	Core	Growth
Large	74.84	62.89	51.10
Mid	103.15	99.99	94.98
Small	94.89	91.26	87.09
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

Five-Year Results Still Show Wide Variations

- Returns are negative for growth.
  - Large cap growth is still quite negative.
- Value, particularly small value, is superior to other styles.

5-Year Returns	Value	Core	Growth
Large	**5.75**	**-1.26**	**-8.62**
Mid	**13.96**	**7.18**	**-4.49**
Small	**15.20**	**6.47**	**-2.52**
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

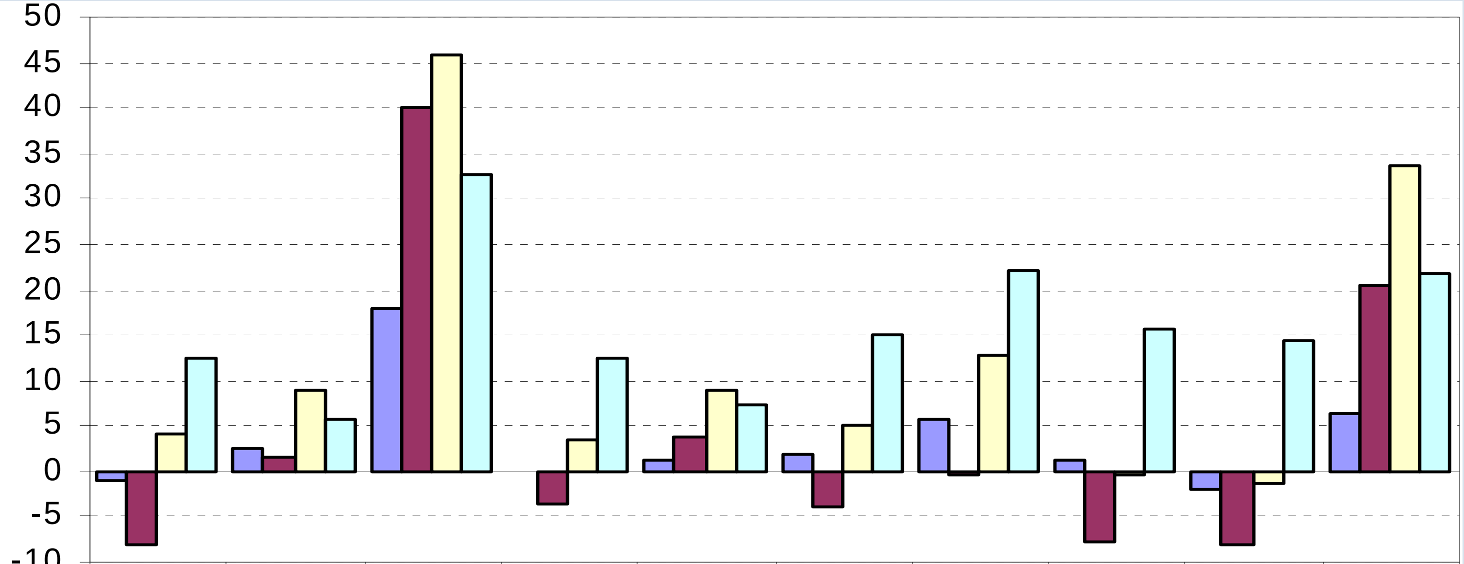
Cumulative 5-Year Results Are Extremely Different, Depending on Market Segment

- Large growth stocks lost more than 36% of their value.
- Small value stocks increased by more than 100%!

Cumulative 5-Yr	Value	Core	Growth
Large	**32.25**	**-6.14**	**-36.28**
Mid	**92.20**	**41.44**	**-20.52**
Small	**102.89**	**36.82**	**-11.98**
Note: Russell 1000, Mid-Cap, 2000 Indices: Value, Core, Growth			

U.S. Equity Markets
Sector Performance

S&P 500 Returns by Sector



	Cons. Discr.	Cons. Stpls.	Energy	Financl.	Health Care	Industrials	Tech.	Materials	Telecom	Utilities
Quarter	-1.11	2.51	17.77	0.07	1.07	1.92	5.80	1.34	-1.97	6.37
YTD	-8.06	1.47	39.96	-3.50	3.79	-3.94	-0.53	-7.60	-8.04	20.36
1 Year	3.99	8.94	45.86	3.45	8.82	5.18	12.79	-0.24	-1.21	33.77
3 Year	12.62	5.72	32.76	12.58	7.23	14.89	22.09	15.63	14.54	21.76

Source: Datastream

U.S. Equity Markets
Top Positive and Negative Contributors

Stock	Return (%)	End of Quarter Weight	Rank
EXXON MOBIL CORP	11.10%	3.68%	1
AMGEN INC	31.77%	0.90%	18
CHEVRON CORP	16.60%	1.34%	12
ALTRIA GROUP INC	15.23%	1.40%	9
QUALCOMM INC	35.87%	0.67%	30
CONOCOPHILLIPS	22.21%	0.89%	19
PROCTER & GAMBLE CO	13.29%	1.34%	11
HEWLETT-PACKARD CO	24.54%	0.77%	24
APPLE COMPUTER INC	45.64%	0.41%	61
HALLIBURTON CO	43.58%	0.32%	74
AMERICAN INTL GROUP INC	6.91%	1.48%	8
VALERO ENERGY CORP	43.05%	0.32%	76
BURLINGTON RESOURCES INC	47.39%	0.28%	86
IBM CORP	8.38%	1.17%	13
MOTOROLA INC	21.19%	0.50%	47
TEXAS INSTRUMENTS INC	20.86%	0.50%	46
GOLDMAN SACHS GROUP INC	19.45%	0.52%	42
EBAY INC	24.81%	0.42%	60
MICROSOFT CORP	3.89%	2.18%	3
DEVON ENERGY CORP	35.59%	0.29%	83
CATERPILLAR INC	23.85%	0.36%	67
TXU CORP	36.64%	0.25%	96
MCDONALDS CORP	20.68%	0.38%	65
GILLETTE CO	15.30%	0.48%	49
TIME WARNER INC	8.68%	0.78%	23

Stock	Return (%)	End of Quarter Weight	Rank
PFIZER INC	-8.79%	1.46%	6
FANNIE MAE	-22.90%	1.87%	63
DELL INC	-13.33%	2.19%	25
BANK OF AMERICA CORP	-6.62%	0.41%	7
WAL-MART STORES INC	-8.78%	2.45%	16
ABBOTT LABORATORIES INC	-12.98%	1.68%	34
GENERAL ELECTRIC CO	-2.19%	0.22%	2
INTEL CORP	-4.97%	1.11%	10
CISCO SYSTEMS INC	-6.03%	1.37%	15
MERCK & CO INC	-10.47%	0.47%	39
FREDDIE MAC	-12.91%	0.73%	68
AVON PRODUCTS INC	-28.31%	0.60%	216
WELLS FARGO & CO	-4.06%	0.21%	17
JOHNSON & JOHNSON	-2.14%	0.62%	5
VERIZON COMMUNICATIONS	-4.26%	0.58%	21
HCA INC	-15.18%	0.43%	121
SPRINT NEXTEL CORP	-5.12%	0.31%	33
JPMORGAN CHASE & CO	-3.01%	0.30%	14
DU PONT EI DE NEMOURS & CO	-8.08%	0.39%	69
COUNTRYWIDE FINANCIAL CORP	-14.20%	0.32%	133
ORACLE CORP	-6.14%	0.69%	57
SYSCO CORP	-13.32%	0.52%	132
COMCAST CORP	-4.21%	0.37%	36
ALLSTATE CORP	-6.94%	0.31%	72
SEARS HOLDINGS CORP	-16.98%	0.95%	215

Data Source: Compustat

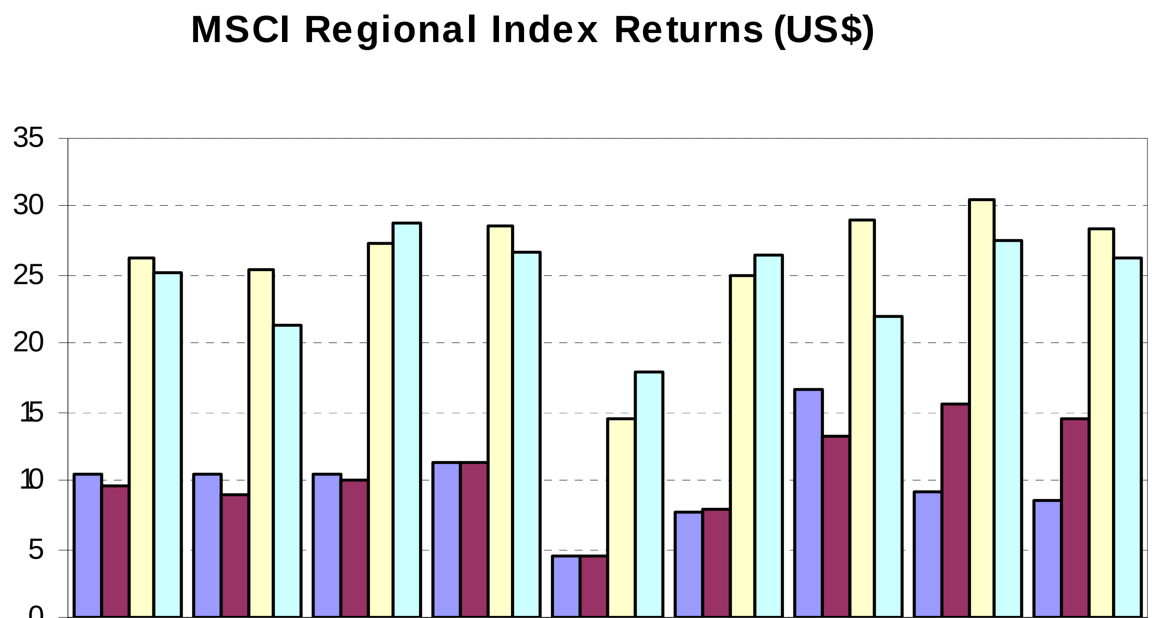
Report Date: November 3, 2005

Utilities | Consumer Staples | Cap Goods | Financials | Health Care | Basic Inds | Info. Tech | Energy | Cons Discretionary

Non-U.S. Equity Markets
International Equities Performed Well Despite Energy Prices and Global Economic Concerns

- The MSCI EAFE advanced 10.4%, with most countries posting gains.
  - Japan returned the largest gain of 19.2%.
  - Other strong returns came from the European region, with Germany and France up 9.7% and 8.7% respectively.
  - Australia, a net energy exporter, gained over 11% for the quarter.
- Currency translation did not materially impact returns for this quarter; however, the U.S. dollar’s appreciation slowed against the euro.
- Emerging market equities posted extremely strong gains, up over 18% for the quarter.

Non-U.S. Equity Markets
EAFE Regional Performance



	EAFE (Free)	EAFE Growth	EAFE Value	EAFE & EMF	North America	Europe	Pacific (incl. Japan)	AC Asia (Free) ex Japan	AC Far East (Free) ex
Quarter	10.44	10.50	10.38	11.40	4.50	7.78	16.56	9.09	8.47
YTD	9.50	8.88	10.13	11.36	4.45	7.79	13.21	15.64	14.60
1 Year	26.32	25.42	27.23	28.69	14.46	24.99	29.09	30.62	28.39
3 Year	25.11	21.32	28.91	26.60	18.01	26.39	22.05	27.63	26.27

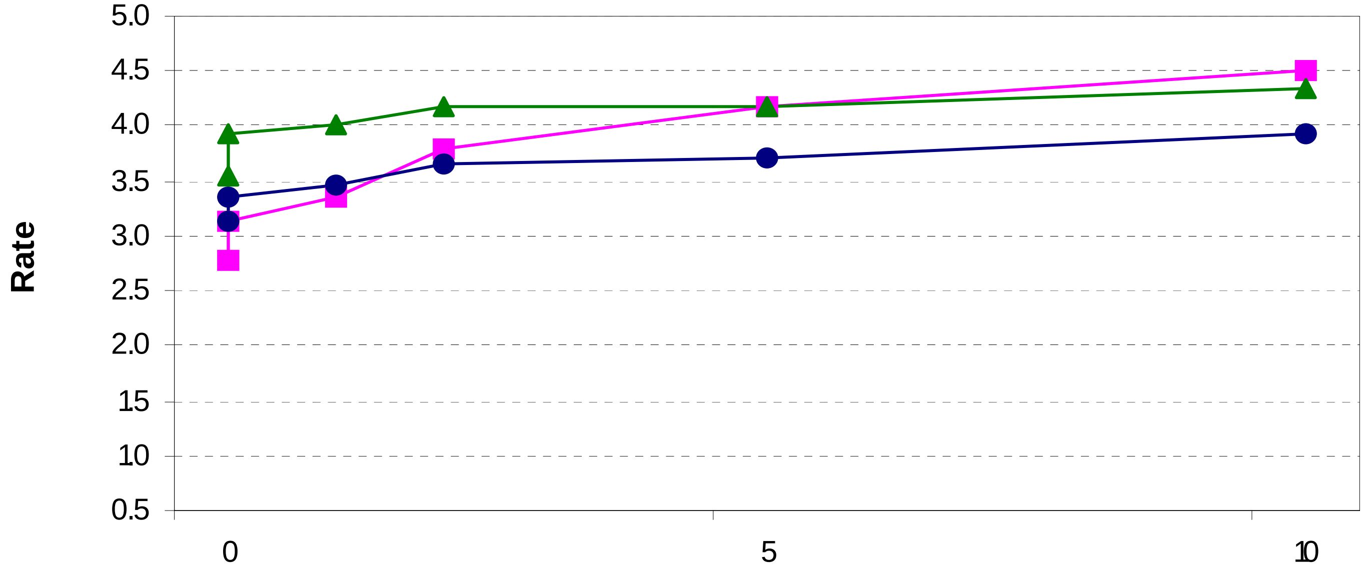
Source: Datastream

Fixed Income Markets
Bond Market Posts Losses; Lower-Quality And Credit Bonds Outperform U.S. Treasuries

- The investment-grade bond market lost ground during the third quarter as yields moved higher. The Lehman Brothers Aggregate Bond Index lost 0.7%, its second-lowest quarterly return of the decade.
- The Lehman Brothers Treasury Index was down 1.1% for the quarter. Long-term Treasuries were hit hardest, losing 2.7%, while intermediate-term Treasuries lost 0.6%.
- The Lehman Brothers Credit Index declined 1.0%. In general, long-term bonds underperformed intermediate-term maturity issues. By quality, losses were least severe for AAA-rated issues.
- The Lehman Brothers MBS Index fell 0.2% during the quarter. The average 30-year mortgage rate rose from 5.53% at June-end to 5.80% in the last week of September.

Yield Curve Flattened Further
Short Rates Continued to Rise While Long Rates Fell

Flattening Yield Curve

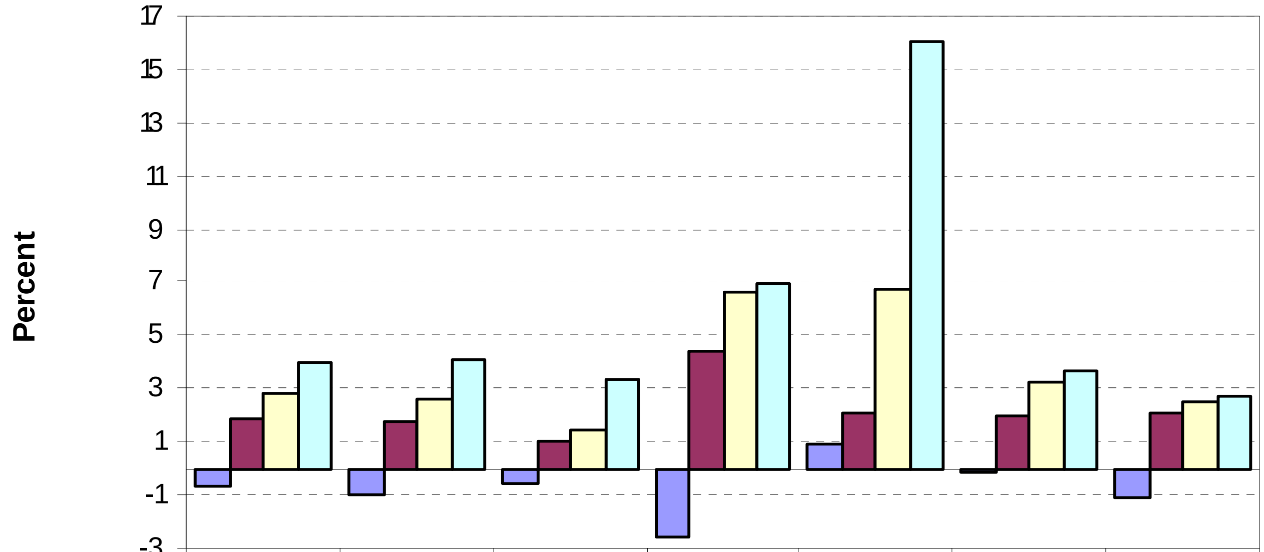


Years	0.25	0.5	1	2	5	10
Mar-05	2.79	3.13	3.35	3.8	4.18	4.5
Jun-05	3.13	3.34	3.45	3.66	3.72	3.94
Sep-05	3.55	3.93	4.01	4.18	4.18	4.34

Source: Datastream

Fixed Income Markets
Index Performance

Domestic Fixed Income Returns



	Lehman Aggregate	Lehman Gov/Corp	Lehman Gov/Corp Int	Lehman Gov/Corp Long	Lehman High Yield	Lehman Mortgage Backed	Lehman Treasury
Quarter	-0.68	-0.97	-0.52	-2.61	0.92	-0.15	-1.12
YTD	1.83	1.74	1.05	4.37	2.05	2.00	2.03
1 Year	2.80	2.56	1.48	6.63	6.72	3.29	2.46
3 Year	3.96	4.13	3.36	6.91	16.01	3.71	2.76

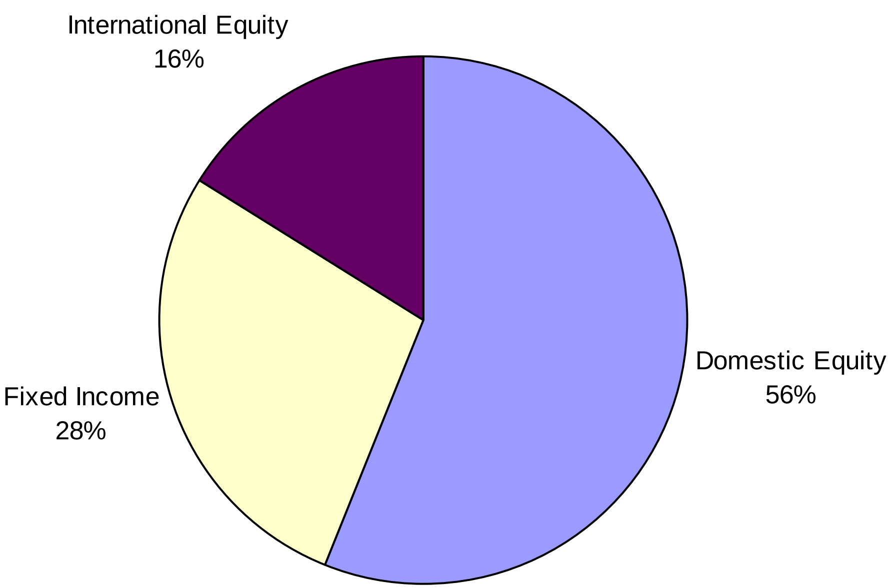
Other Asset Classes

- **Real Estate**
  - REITs continued to advance during the quarter as the NAREIT Equity Index gained 3.8%. The dividend yield at quarter-end was 4.56%, down from 5.12% a year ago.
  - The latest data available for the private real estate market showed a second-quarter gain of 5.3% for the NCREIF Property Index.
- **Inflation Indexed Bonds**
  - Treasury Inflation-Protection Securities (TIPS) showed no gain for the quarter, but led Treasuries by 113 basis points.
- **International Bonds**
  - The Citigroup Non-U.S. Government Bond Index lost ground for the third consecutive quarter, declining 1.1% in U.S. dollar terms. On a dollar-hedged basis, the Index gained 0.3%.

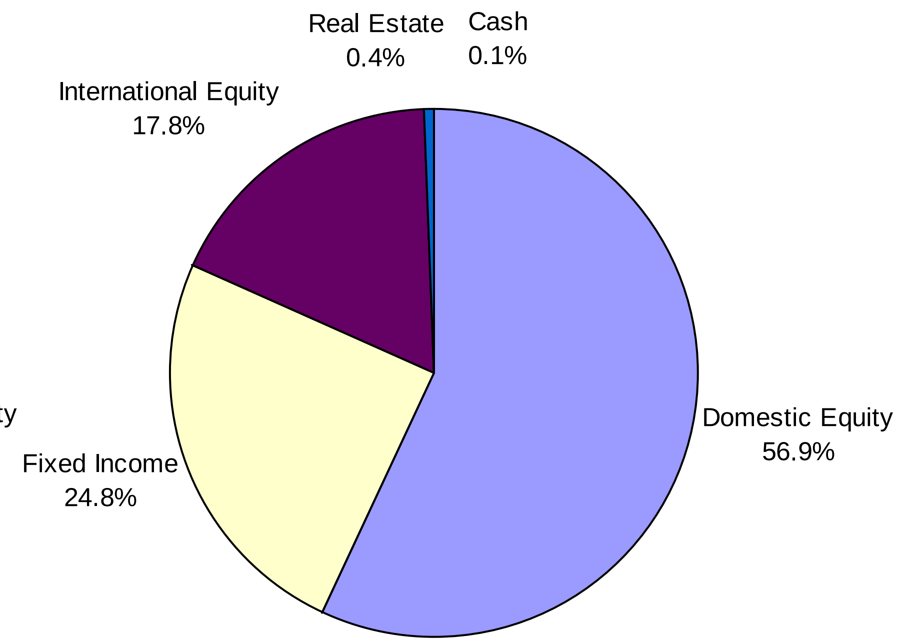
ASRS Total Fund Performance

Total Fund Asset Allocation
September 30, 2005

Policy Adjusted for Transition into Real Estate

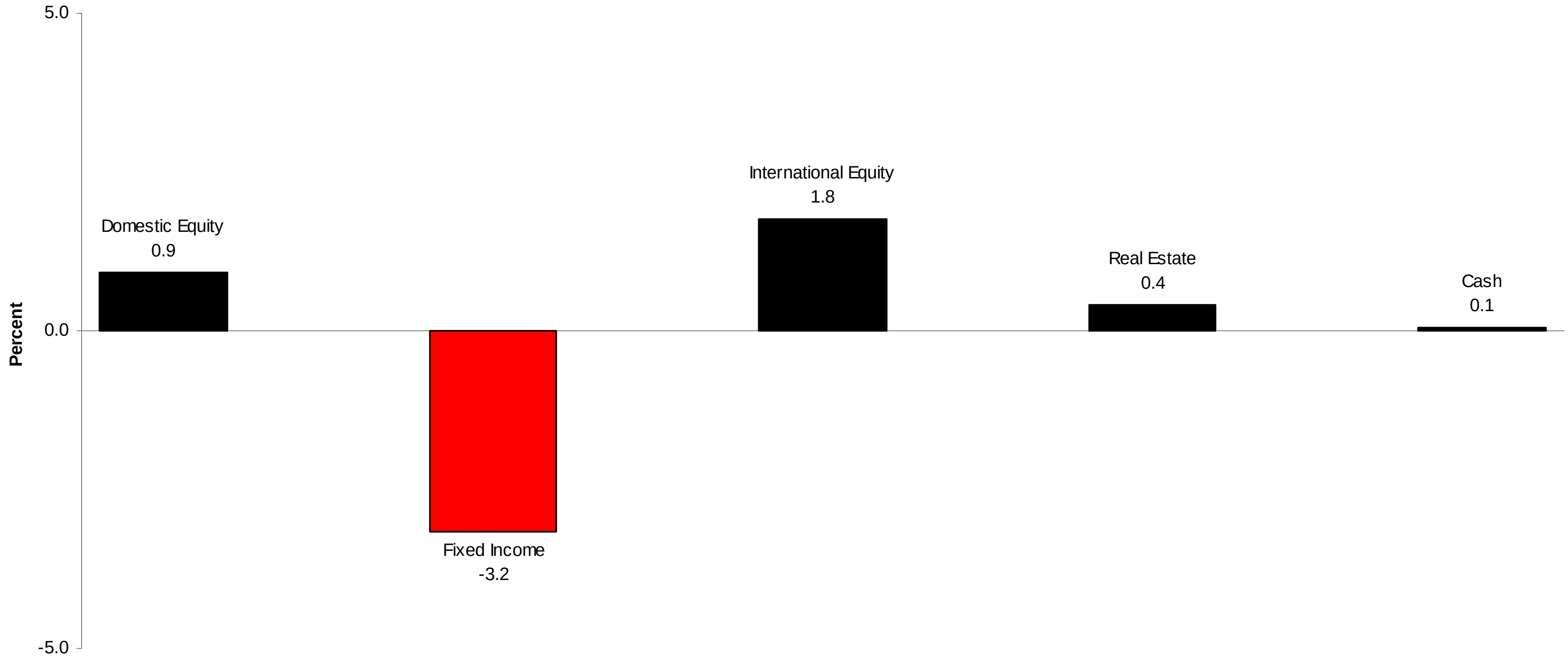


Actual Asset Allocation



Total Fund Asset Allocation
September 30, 2005

Actual Asset Allocation vs. Policy Adjusted for Transition into Real Estate



Total Fund Performance
For Periods Ending September 30, 2005

	Quarter	1 Year	3 Years	5 Years	10 Years
Total Fund	3.7%	12.9%	15.2%	3.0%	9.2%
Benchmark*	3.5	11.8	14.5	2.2	7.9
Excess Return	0.2	1.1	0.7	0.8	1.3

* Interim Benchmark of 56% S&P 500/28% LB Aggregate/16% EAFE, which incorporates a proration of 6% real estate.

Policy History:
- 7/1/87-12/31/91 – 60% S&P 500/40% LB Aggregate
- 1/1/92-12/31/94 – 50% S&P 500/40% LB Aggregate/10% EAFE
- 1/1/95-6/30/97 – 45% S&P 500/40% LB Aggregate/15% EAFE
- 7/1/97-12/31/99 – 50% S&P 500/35% LB Aggregate/15% EAFE
- 1/1/00-9/30/03 – 53% S&P 500/30% LB Aggregate/17% EAFE
- 10/1/03-present – 53% S&P 500/26% LB Aggregate/15% EAFE/6% Custom Real Estate Benchmark.

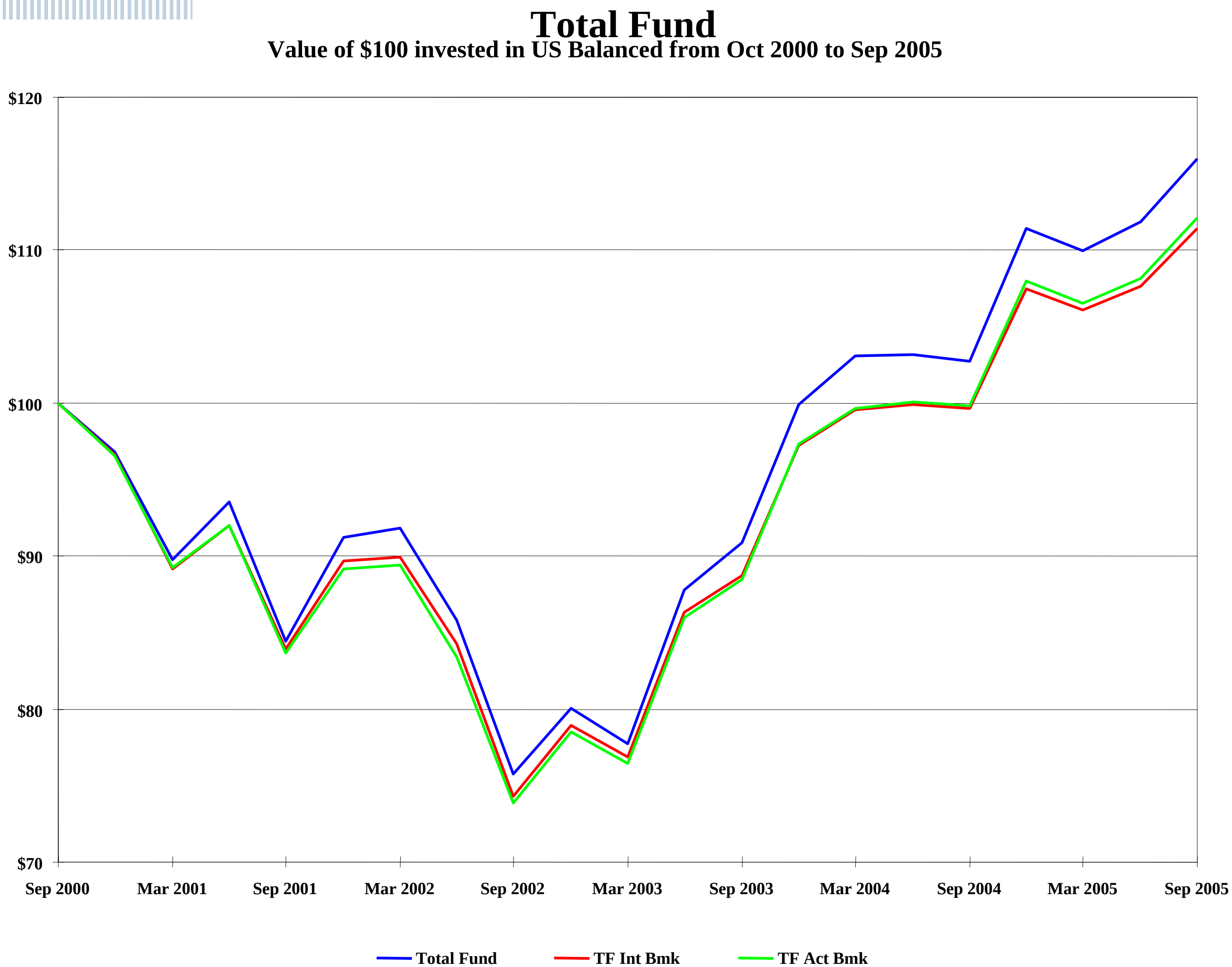
Total Fund Ranking
For Periods Ending September 30, 2005

	1 Year	3 Years	5 Years	10 Years
Russell/Mellon Trust Universes				
Master Trust Funds - Total Funds	62	46	75	49
Total Funds - Public	84	65	95	38
Total Funds Billion Dollar - Public	89	75	95	45
Total Funds - Corporate	59	48	67	49
Wilshire Trust Universe Comparison Service				
Master Trusts - All	59	41	74	64
Public Funds	55	32	79	43
Public Funds Greater than $1.0 Billion	63	36	85	37
Corporate	60	41	69	75
Callan Associates Inc.				
Total Funds	61	36	78	46
Public Funds	56	29	85	21
Public Funds - Large (>1B)	78	41	91	27
Corporate Funds	52	28	74	62

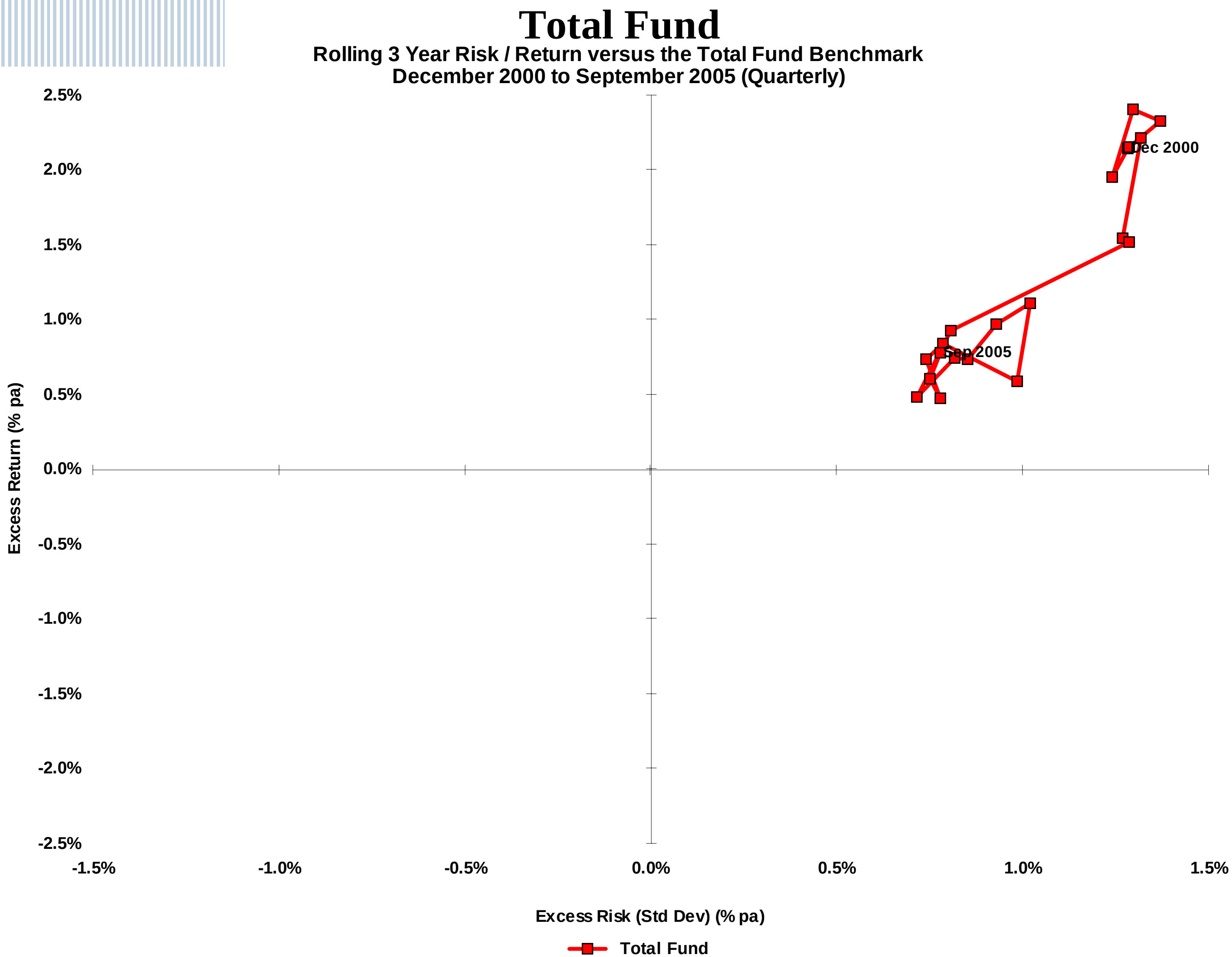
Total Fund Performance
For Periods Ending September 30, 2005

		1 Year	3 Years	5 Years	10 Years
	ASRS Total Fund	12.9%	15.2%	3.0%	9.2%
1)	Asset Allocation Target	7.4%	7.7%	8.0%	8.5%
	Excess Return	5.5%	7.5%	-5.0%	0.7%
2)	CPI Inflation + 3.75%	8.4%	6.9%	6.5%	6.4%
	Wage Inflation + 3.75%	7.6%	6.3%	7.1%	6.7%
	Excess Return - CPI	4.5%	8.3%	-3.5%	2.8%
	Excess Return - Wage	5.3%	8.9%	-4.1%	2.5%
3)	Actuarial Assumption	8.0%	8.0%	8.0%	8.0%
	Excess Return	4.9%	7.2%	-5.0%	1.2%

Total Fund Growth



Risk/Return Analysis



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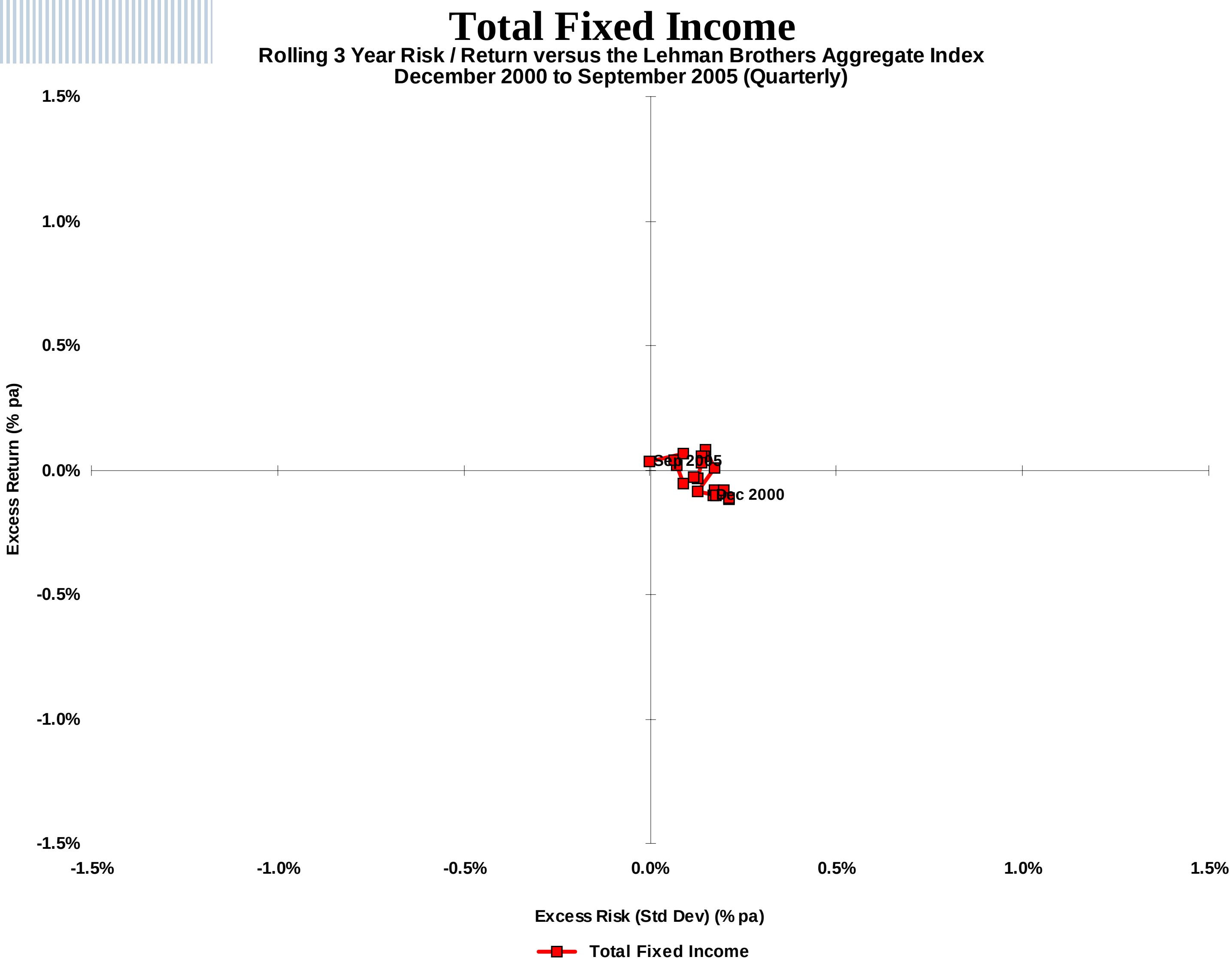

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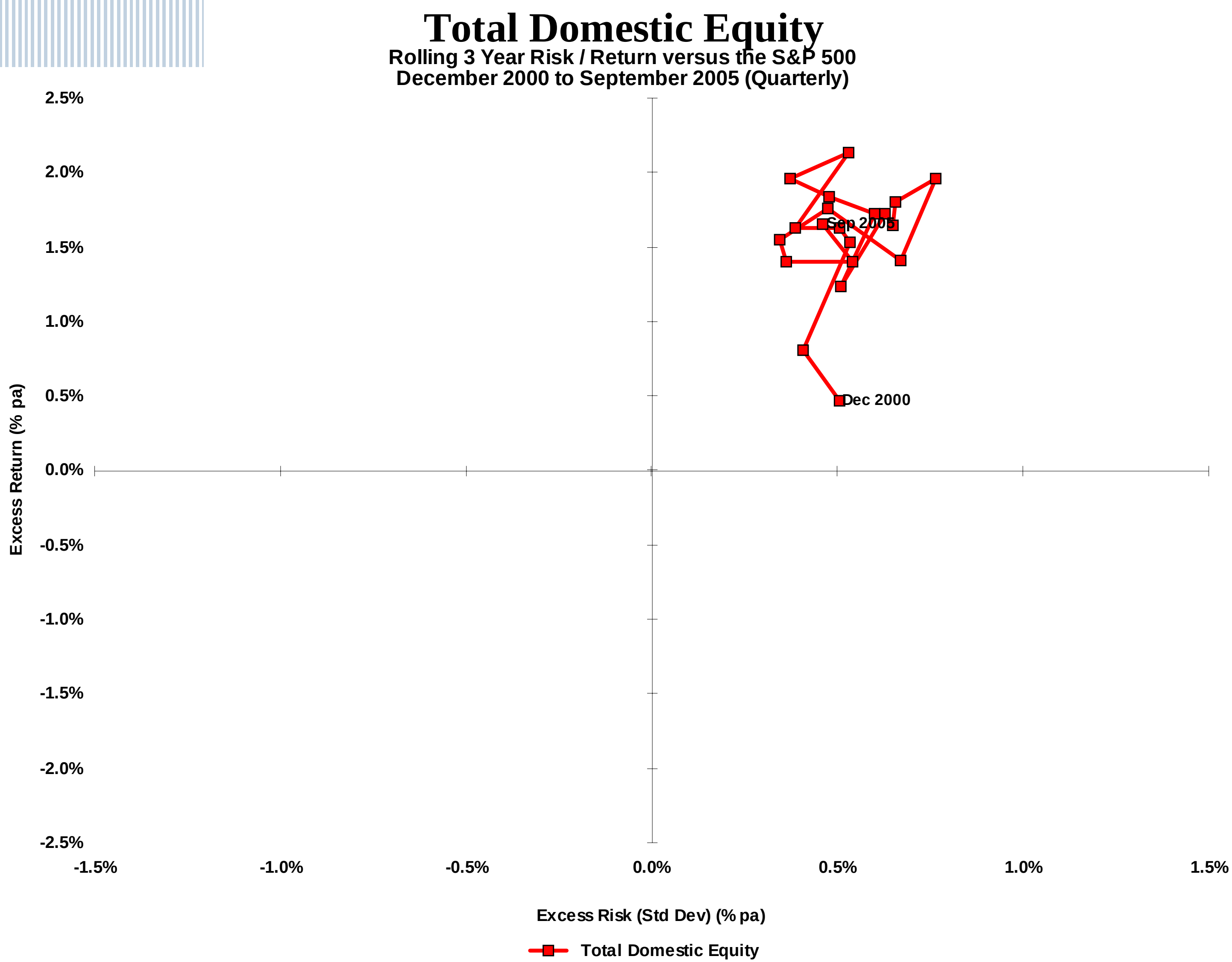
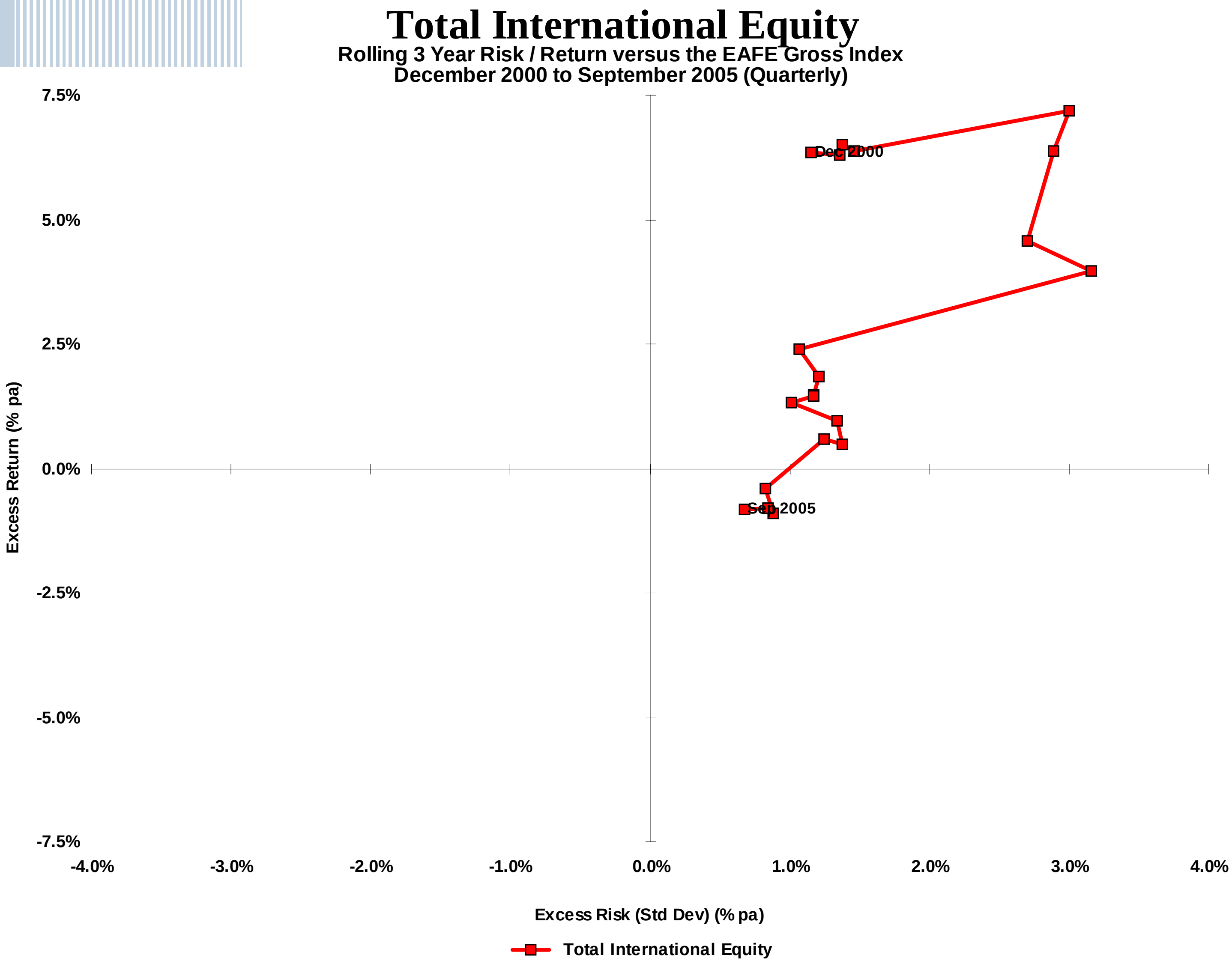


Risk/Return Analysis



Performance vs. Benchmarks
For the 3 Years Ending September 30, 2005

	Return	Assumed ROR	Std. Dev.
Total Fund	15.2%	7.7%	9.6%
Benchmark*	14.5		9.2
Domestic Fixed	4.0	4.9	3.5
LB Aggregate	4.0		3.5
Domestic Equity	18.4	8.8	12.3
S&P 500	16.7		11.9
Intl. Equity	24.3	9.0	17.5
EAFE	25.1		16.8

* Interim Benchmark of 56% S&P 500/28% LB Aggregate/16% EAFE, which incorporates a proration of 6% real estate.

Performance vs. Benchmarks
For the 5 Years Ending September 30, 2005

	Return	Assumed ROR	Std. Dev.
Total Fund	3.0%	8.0%	13.2%
Benchmark*	2.2		12.6
Domestic Fixed	6.7	5.2	4.0
LB Aggregate	6.6		4.0
Domestic Equity	0.3	9.0	19.1
S&P 500	-1.5		18.5
Intl. Equity	3.9	9.4	21.0
EAFE	3.5		20.6

* Interim Benchmark of 56% S&P 500/28% LB Aggregate/16% EAFE, which incorporates a proration of 6% real estate.